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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Uruguay: A New Government Faces Old Economic Problems

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1972

INTELLIGENCE MEMORANDUM

URUGUAY: A NEW GOVERNMENT FACES OLD ECONOMIC PROBLEMS

Introduction

1. On 1 March 1972, when Juan Bordaberry became Uruguay's president, the economy was still beset by the fundamental problems that began to plague it in the mid-1950s. The reforms instituted by the administration of Jorge Pacheco, which had been in power since late 1967, brought some gains but did not materially improve the underlying economic situation. Even these reforms were gutted in the pre-election search for popular support. The new government has adopted many of the policies followed initially by the Pacheco administration. There is no certainty, however, that Bordaberry will achieve a similar degree of success or would be able to use it as a springboard for much-needed structural changes. This memorandum briefly describes Uruguay's longstanding economic problems and Pacheco's efforts to deal with them. It also discusses the economic situation facing the new government and analyzes Bordaberry's initial policies and their prospects for success.

Discussion

Background

2. Before the mid-1950s, Uruguay's economic prosperity and political stability stood out among Latin American nations. Thriving livestock exports and substantial investment in import-substitution industries kept Uruguay's gross domestic product (GDP) growing at about 5% annually, and income per capita at almost as high a rate. Price increases were small and the peso's stability enabled Montevideo to become an important international banking center. The longstanding viability of its democratic institutions and the steady expansion of benefits under one of the world's most advanced welfare systems also set the country apart from its neighbors. To all outward appearances, Uruguay deserved its reputation as the "Switzerland of Latin America."

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

3. Nevertheless, potential economic weaknesses underlay the prosperity. A high-cost industrial sector based largely on imported raw materials had been built behind the protection of high tariff walls and favorable tax policies. The domestic market was small, and Uruguayan manufactured goods had little export potential. The economy thus remained dependent on agriculture for foreign exchange earnings, and much of the fiscal burden of the government's welfare programs was borne by this sector as well. As government policies favoring the growing urban populace at the expense of the rural sector reduced agricultural investment incentives, production of major export commodities began to stagnate. At the same time, rising domestic consumption reduced the portion of output available for export.

4. The fall in world market prices for Uruguay's major exports after the Korean War fully exposed the economy's basic weaknesses. Exports dropped 22% from 1953 to 1957, and foreign exchange reserves were drawn down sharply to pay for continuing large imports. Rapid expansion of private credit in the late 1950s and early 1960s increased inflationary pressures without stimulating production as intended. After 1964, rising budget deficits also helped to fuel one of the world's highest inflation rates, which destroyed Uruguay as an international banking center and created considerable social and political unrest. As a result of this complex of problems, economic activity stagnated and per capita GDP fell some 15% during 1955-68.*

5. In the face of a decline in real national income, successive administrations opted to preserve consumption levels at the expense of a sharp decline in investment. Moreover, welfare expenditures were allowed to absorb an increasing share of the country's available resources. Social security costs rose steadily as benefits were increased and coverage expanded. By 1968 such expenditures equaled 5.5% of GDP, and some 300,000 people – or 30% of the labor force – were directly receiving benefits of some kind. The relatively low minimum retirement age of 50 years tempted workers to retire from one job in order to receive a pension while working for another employer at full salary. As the continued economic malaise brought an acute shortage of productive jobs, the government became an employer of last resort, swelling the bureaucracy until more than one-fourth of the labor force was publicly employed.

The Economy under Pacheco

6. When Jorge Pacheco assumed the presidency upon the death of his predecessor in December 1967, Uruguay's economic situation was little short of calamitous. During the year, GDP had fallen 5% in real terms, exports had dropped 15%, payments on external public debt had risen to

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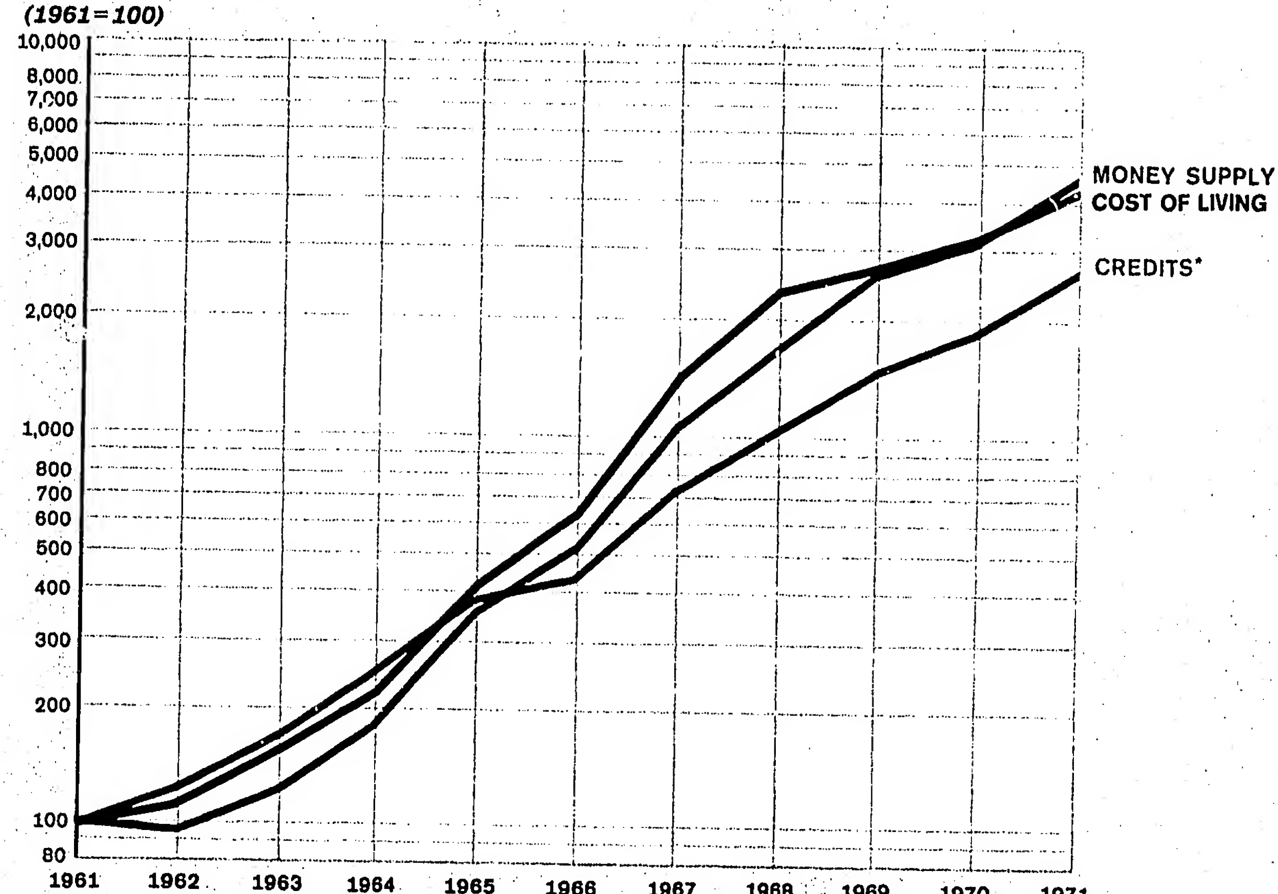
20% of foreign exchange earnings, and the cost of living had soared 136%. The new president attacked these problems with extraordinary determination. In June 1968 he imposed a limited state of siege to curtail labor and student agitation and decreed an unprecedented freeze on wages and prices. Although the government also tried to cut the budget deficit and slow monetary expansion, these efforts were much less forceful than called for. The Pacheco administration's remarkable success in braking the inflationary spiral (see Figure 1) thus must be attributed largely to its incomes policy. The cost-of-living index, which had jumped 63% during the first six months of 1968, increased only 2% during the second half of the year. Because some wage rate adjustments were allowed to ease the inequities of a blanket freeze, real wages improved markedly during July-December 1968. The government's incomes policy in 1969 and 1970, which permitted relatively moderate wage and price rises at scheduled intervals, succeeded in holding cost-of-living increases to 15% and 20%, respectively – the lowest rates since 1962. Although collective bargaining rights remained suspended, government-decreed wage increases generally maintained real wage levels during this period.

7. The administration's success in quelling inflation created a more favorable business climate and thereby encouraged the growth of investment, output, and exports. After several years of almost uninterrupted decline – which continued into Pacheco's first year in office – fixed investment during 1969-70 rose at an average rate of 15% annually in real terms (see Figure 2). By 1970, investment represented some 10% of GDP – still a very low share but two percentage points above the 1965-68 average. Production, which had stagnated since 1955, moved forward at a 4% average annual rate during 1968-70 (see Figure 3), and unemployment fell from 20% to 10% of the labor force. In response to a wide variety of government incentives – including a 20% devaluation in April 1968 – exports increased by about 14% annually during 1968-70. In 1970 they reached their highest level since 1954.

8. With the approach of the November 1971 elections, many elements of Pacheco's economic program were abandoned for political reasons. During 1971, larger and more frequent wage increases were decreed, and, as the political campaign quickened, price and credit controls were relaxed and budget restraint neglected. As a result, the cost-of-living index jumped 24% during the last half of 1971, more than offsetting wage gains. Exports became less competitive as domestic prices rose, and the government held back from a politically damaging devaluation. Government imposition of low price ceilings on beef led to widespread smuggling of cattle to Brazil, where prices ranged between 20% and 100% higher. As a result, legal exports fell to US $203 million in 1971 (see Figure 4), compared with US $233 million in 1970, and deteriorated even more rapidly in early 1972. Net foreign reserves in 1971 dropped from US $32 million to US -$34 million,

Figure 1

URUGUAY: Selected Measures of Financial Instability



*Does not include private credit extended through the large unregulated parallel market.

CENTRAL GOVERNMENT BUDGET DEFICIT OR SURPLUS AS A PERCENT OF EXPENDITURES

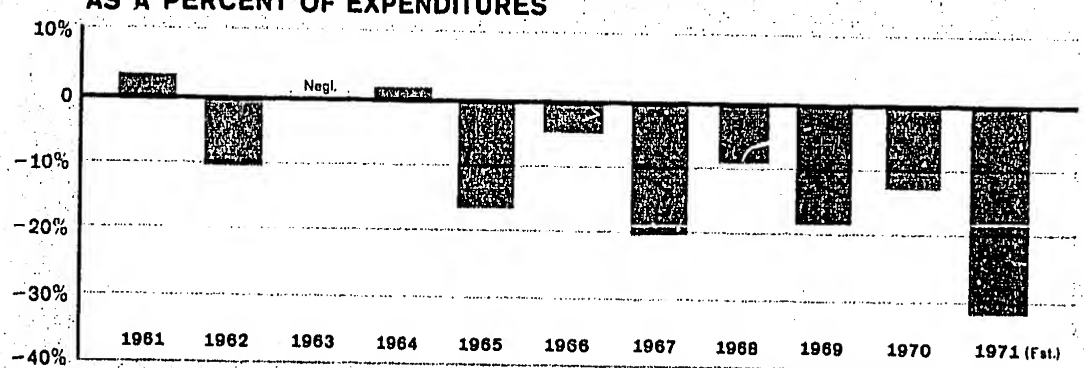


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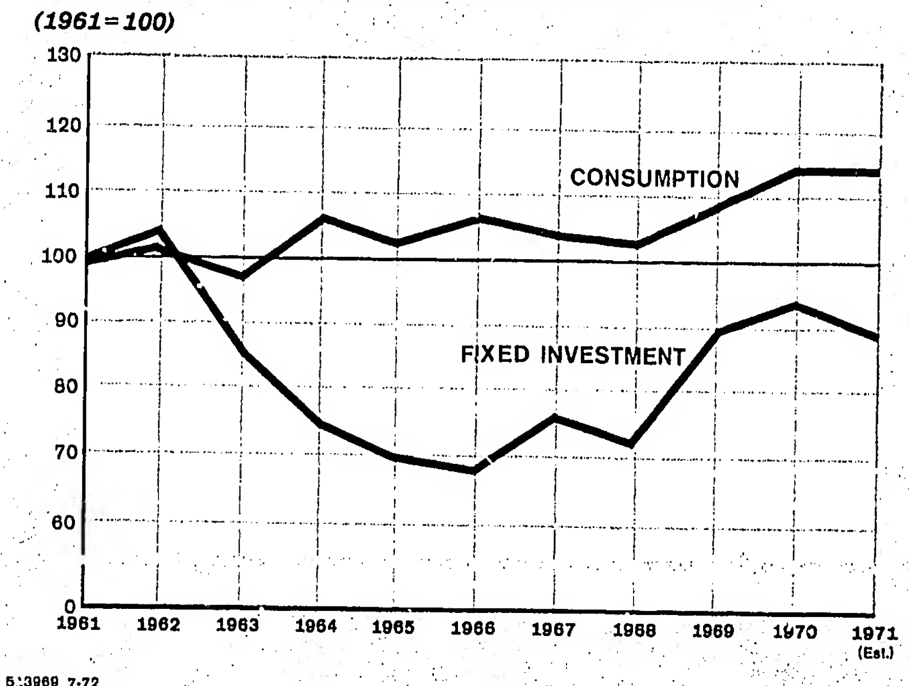
Figure 2

URUGUAY
Trends in Fixed Investment and Consumption



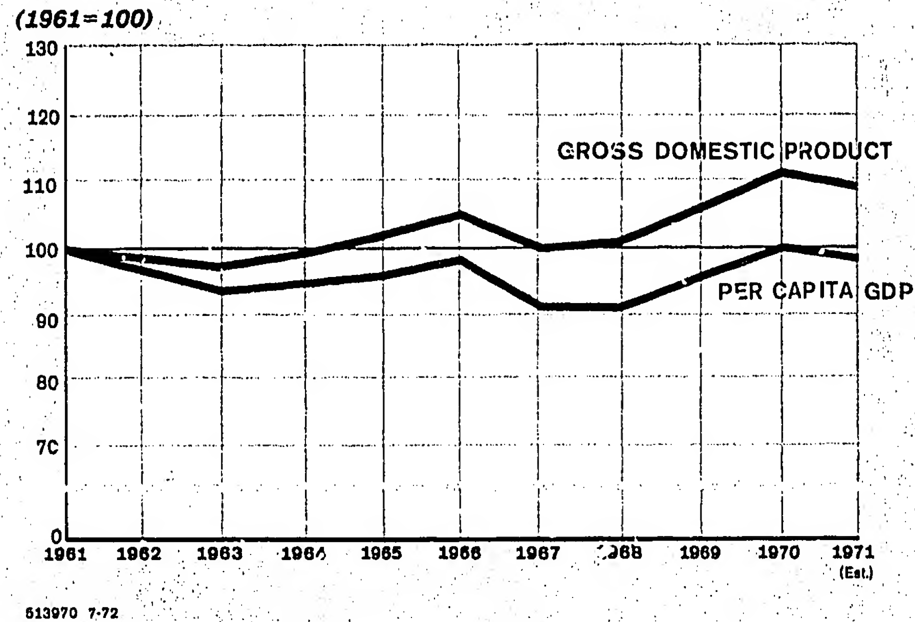
reflecting not only lower export earnings but also renewed capital flight brought about by the deteriorating economic and political situations. Total output dropped for the first time since Pacheco took over, mainly because government pricing policies reduced beef production.

<u>The New Government's First Moves</u>

9. Juan Bordaberry campaigned as a supporter of an economic hard line, and his first moves as president resembled Pacheco's early steps. The day after taking office, Bordaberry devalued the peso and established a dual exchange rate system much like Argentina's. The "trade" rate, used for merchandise trade and public sector financial transactions, was established at 500 pesos to the dollar, an effective devaluation of 35%.

Figure 3

URUGUAY: Trends in Gross Domestic Product



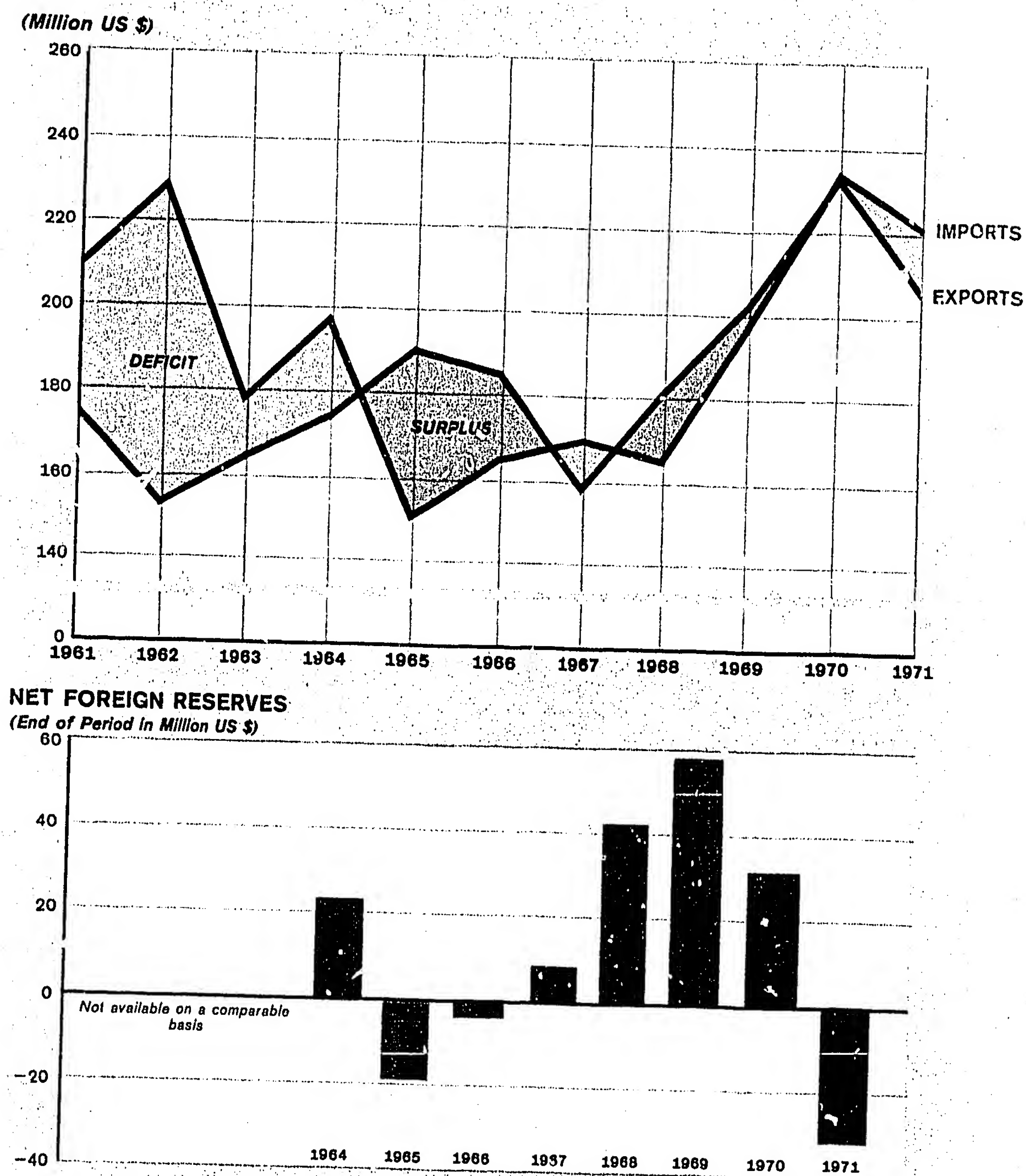
The "financial" rate, used for all other transactions, generally has been allowed to float in response to changing supply and demand, with occasional government intervention. In recent weeks, it has ranged between 850 and 900 pesos to the dollar. The trade rate is to be adjusted frequently in line with internal price changes. Three such "mini-devaluations" totaling 12.6% occurred in April, May, and June.

10. President Bordaberry also adopted a tough program aimed at encouraging legal beef exports, which usually account for about one-third of total exports. The enforcement of smuggling laws has been tightened, and Brazilian support for the anti-smuggling campaign has been obtained. At the same time, the government has repeatedly stated that it will not allow cattle prices to rise above the January level – a policy that it hopes will keep ranchers from holding their cattle to obtain higher prices. More drastic measures were taken to cut beef consumption. Steer slaughter for the domestic market was prohibited beginning in April, and cattle slaughter for this purpose is to be banned completely from July through November.

11. Like its predecessor, the new government started out by tightening wage and price controls and by taking a hard look at the budget. Shortly

Figure 4

URUGUAY: Exports, Imports, and Net Foreign Reserves



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after coming to power, the government allowed wage increases of 20% for the private sector and 15% for the public sector, but these increases were much less than labor demanded and not enough to avoid a deterioration in real wages. No additional increases are scheduled until late this year. Bordaberry plans to reduce the budget deficit from 31% of expenditures in 1971 to 16% this year primarily by raising export tax returns and strictly controlling spending. Commercial bank reserve requirements and interest rates have been raised to slow credit expansion. Fulfillment of these goals, which is a condition of the recently extended International Monetary Fund (IMF) standby credit, should sharply reduce the inflation rate during the rest of 1972. Because of the sharp cost-of-living rise in the early part of the year, however, the 1972 inflation rate will exceed 45% even if rigorous price controls are maintained in the months ahead.

12. The government thus far has given its anti-inflation program priority over moves to stimulate production. Although the government's economic team is drafting a medium-term development plan that should increase public investment, direct proportionately more credit to productive sectors, and provide various other production incentives, it is unlikely that the plan will be put into effect before the end of the year. In the meantime, Bordaberry is probably counting on an improved business climate and a rejuvenated export sector to bring some upturn in economic activity. Some improvement in foreign investor confidence is already evident. Fiat, for example, recently announced its decision to build a $9 million automobile assembly plant in Uruguay that will produce mainly for export.

13. Perhaps the most serious immediate problem facing the new government is the heavy foreign debt servicing requirements due this year. Scheduled payments on medium- and long-term public debt alone total $87.5 million – equal to some 35% of 1971 foreign exchange earnings. The total debt servicing burden in 1972 probably is considerably more than double that amount, although information on private foreign debt, short-term obligations, and payments arrears is sketchy. The Bordaberry government is actively seeking to refinance its foreign debt – an effort in which it will probably succeed if only because scheduled payments are clearly beyond Uruguay's capabilities. In addition, Bordaberry has stated that a part of Uruguay's $150 million in official gold reserves will be sold on the free market, where prices recently soared to nearly $65 an ounce. This gold was pledged as loan collateral to various foreign banks over the last few years at then prevailing free market prices, which ranged from $35 to $42 an ounce. Short-term financing to free the gold is being negotiated, and the government expects to realize a profit of some $10 million to $15 million above the pledged value of $49.5 million. The Bordaberry government will also be helped by the recent extension by the IMF of a $21.7 million standby loan and a compensatory loan of $18.7 million to offset the shortfall in 1971 export earnings.

Conclusions and Prospects

14. The early successes of the Pacheco economic program show the economy's ability to respond rapidly to strong measures, and its eventual failure underscores the difficulty of maintaining a hard line in the country's highly politicized atmosphere. Even if Pacheco had been able to pursue his program for a longer period, it would have done little to correct the economy's basic distortions. Pacheco made no attempt to bring the overgrown welfare system in line with the country's capabilities, nor did he try to streamline the bloated government bureaucracy. No redirection of industry from high-cost import substitution was attempted, and only the smallest beginnings of a new agricultural policy were carried out.

15. Like Pacheco, Bordaberry has been preoccupied with immediate political and economic problems and apparently has not devised a comprehensive plan of attack on the economy's structural distortions. Such moves as he has made, however, are in the right direction. He has substantially raised prices for public goods and services in an effort to make the state enterprises self-supporting. He has announced a policy of reducing public employment by allowing vacancies to go unfilled in both the state enterprises and the central government bureaucracy. He is pursuing a livestock development plan, originally drawn up and partly financed by the World Bank in 1959 but suspended during 1965-69, to expand improved pastures, build up breeding stock, and shift from wool to mutton and lamb production. Moreover, he intends to implement an existing tax on underutilized land that should force increases in agricultural production. These moves, however, do not go far enough, and other structural problems – especially in manufacturing – have not been touched.

16. Even limited reforms will be easier to effect if economic activity picks up, as now seems likely for at least the next year or so. The return to relative price stability should improve producer and investor incentives sufficiently to bring some economic upturn later this year and perhaps a 3% to 4% GDP rise in 1973. Legal beef exports have already begun to respond to seasonal factors and should receive additional boosts from anti-smuggling measures, the ban on domestic sales, and continuing mini-devaluations. Imports are expected to decline somewhat because of the more realistic exchange rates now in effect. Moreover, if the government is able to continue its successes in combating Tupamaro terrorism – as now seems probable – the recent recovery in tourist receipts should persist. Under these circumstances, and assuming that foreign creditors will refinance scheduled debt payments, net foreign reserves should increase between now and the end of the year.

17. Unfortunately, the expected near-term improvement may merely represent the upswing in another political-economic cycle rather than the

beginning of sustained growth. As in the early months of the Pacheco administration, a large segment of the population now appears to be willing to make some sacrifices for the public good. The public and the politicians – for the moment at least – are accepting beef restrictions, wage and price controls, and other hard-line policies. This more accommodating mood can be expected to last until some of the most immediate problems are solved. But, by the time campaigning for the 1976 elections begins, if not considerably sooner, the Uruguayan people will probably be demanding – and the Uruguayan politicians accepting – the virtual abandonment of constructive, far-sighted economic policies. The stage would then be set for a new crisis, a new strong man, and another ephemeral economic reform program.

18. Uruguay may well be able to continue responding in a minimal fashion to each crisis that arises and living with economic stagnation longer than most countries. According to recent estimates, its population growth rate is now approaching zero and a decline in population by the 1980s is possible. Although many Uruguayans leaving the country are of working age, the economic costs involved are relatively small because of prevailing high rates of unemployment and underemployment. Under these conditions, Uruguayans probably can maintain their still relatively high living standards for an indefinite period without affecting the basic structural changes needed for sustained growth.

19. Even if Bordaberry's economic policies are continued for a long period, they probably would not return Uruguay to the prosperity and stability that it knew before the mid-1950s. Without profound and unlikely structural changes, Uruguay cannot hope to sustain economic growth for any long period. Nor will earnings from agriculture – despite rising world beef demand – be sufficient to support the nation's import-substitution industries and welfare system at earlier levels. Yet, it is probably unrealistic to expect Uruguayans to give up voluntarily the advantages of their increasingly inefficient welfare state or attempt the difficult and uncertain shift from import- to export-oriented industry. Thus, at best, the next few years may bring somewhat less inflation and a bit more production, fewer people on welfare, and more efficiency in agriculture. Uruguay's claim to being the "Switzerland of Latin America" would appear to be a thing of the past.